

1                   IN THE SUPREME COURT OF THE UNITED STATES

2   - - - - -X

3   COMMISSIONER OF INTERNAL               :

4       REVENUE,                               :

5                   Petitioner               :

6               v.                               :   No. 03-892

7   JOHN W. BANKS, II;                       :

8   and                                        :

9   COMMISSIONER OF INTERNAL               :

10   REVENUE,                               :

11                   Petitioner               :

12               v.                               :   No. 03-907

13   SIGITAS J. BANAITIS.                   :

14   - - - - -X

15   Washington, D.C.

16   Monday, November 1, 2004

17               The above-entitled matter came on for oral

18   argument before the Supreme Court of the United States at

19   10:03 a.m.

20   APPEARANCES:

21   DAVID B. SALMONS, ESQ., Assistant to the Solicitor

22       General, Department of Justice, Washington, D.C.; on

23       behalf of the Petitioner.

24   PHILIP N. JONES, ESQ., Portland, Oregon; on behalf of

25       Respondent Banaitis.

1 JAMES R. CARTY, ESQ., Los Angeles, California; on behalf  
2 of Respondent Banks.  
3  
4  
5  
6  
7  
8  
9  
10  
11  
12  
13  
14  
15  
16  
17  
18  
19  
20  
21  
22  
23  
24  
25

|    |                                  |      |
|----|----------------------------------|------|
| 1  | C O N T E N T S                  |      |
| 2  | ORAL ARGUMENT OF                 | PAGE |
| 3  | DAVID B. SALMONS, ESQ.           |      |
| 4  | On behalf of the Petitioner      | 4    |
| 5  | PHILIP N. JONES, ESQ.            |      |
| 6  | On behalf of Respondent Banaitis | 30   |
| 7  | JAMES R. CARTY, ESQ.             |      |
| 8  | On behalf of Respondent Banks    | 44   |
| 9  | REBUTTAL ARGUMENT OF             |      |
| 10 | DAVID B. SALMONS, ESQ.           |      |
| 11 | On behalf of the Petitioner      | 55   |
| 12 |                                  |      |
| 13 |                                  |      |
| 14 |                                  |      |
| 15 |                                  |      |
| 16 |                                  |      |
| 17 |                                  |      |
| 18 |                                  |      |
| 19 |                                  |      |
| 20 |                                  |      |
| 21 |                                  |      |
| 22 |                                  |      |
| 23 |                                  |      |
| 24 |                                  |      |
| 25 |                                  |      |

1  
2  
3  
4  
5  
6  
7  
8  
9  
10  
11  
12  
13  
14  
15  
16  
17  
18  
19  
20  
21  
22  
23  
24  
25

P R O C E E D I N G S

(10:03 a.m.)

JUSTICE STEVENS: We'll hear argument in two cases, the Commissioner of Revenue -- Internal Revenue against Banks and the Commissioner against Banaitis.

Mr. Salmons.

ORAL ARGUMENT OF DAVID B. SALMONS

ON BEHALF OF THE PETITIONER

MR. SALMONS: Thank you, Justice Stevens, and may it please the Court:

Section 61(a) of the Internal Revenue Code defines gross income to include all income from whatever source derived. As this Court has held, that definition is sweeping and represents an intent by Congress to exert the full measure of its taxing power.

The court of appeals decisions below, by excluding from respondent's gross income the portion of litigation proceeds paid to their attorneys under contingent fee agreements, is inconsistent with two longstanding Federal tax law principles for defining gross income.

JUSTICE O'CONNOR: Now, if -- if this didn't involve the alternative minimum tax, would the amount be deductible?

MR. SALMONS: Your Honor, but for the

1 alternative minimum tax, there would be an -- a  
2 miscellaneous itemized deduction --  
3 JUSTICE O'CONNOR: Right.  
4 MR. SALMONS: -- under section 212 of the  
5 code --  
6 JUSTICE O'CONNOR: Right.  
7 MR. SALMONS: -- that would be subject to the  
8 limit of the 2 percent of adjusted gross income that  
9 applies to itemized deductions. But section  
10 56(b)(1)(A) --  
11 JUSTICE SCALIA: That's of annual income.  
12 Right? 2 percent of -- of the person's annual income?  
13 MR. SALMONS: Of the adjusted gross income.  
14 JUSTICE SCALIA: For the year.  
15 MR. SALMONS: For the year. That's correct,  
16 Your Honor.  
17 JUSTICE SCALIA: But, gee, in the case of a --  
18 of a major award, that 2 percent is very likely to be  
19 exceeded, isn't it?  
20 MR. SALMONS: It -- it certainly may, Your  
21 Honor.  
22 JUSTICE SCALIA: So this is a problem that's  
23 going to exist even -- even after the alternate minimum  
24 tax is abolished. Right?  
25 (Laughter.)

1                   MR. SALMONS: I'm not sure entirely what you're  
2 referring to as the problem, but it is the case that --  
3 that --

4                   JUSTICE SCALIA: Well, you don't think -- the  
5 Government doesn't think it's a problem. I'm talking  
6 about taking a huge percentage of the -- of the person's  
7 recovery. That -- that will happen even -- even in the  
8 case where there's no minimum tax -- alternative.

9                   MR. SALMONS: That is correct. That -- that is  
10 correct, Your Honor. Now, I mean -- and let me make two  
11 points about that.

12                   The first is that as a -- as a general matter,  
13 the tax code defines gross income expansively, and there's  
14 a number of this Court's cases that make that clear. Then  
15 -- then the question becomes are there deductions provided  
16 that allow for certain expenses to be deducted.

17                   JUSTICE O'CONNOR: Don't some States such as  
18 Oregon require a plaintiff to remit a portion of punitive  
19 damages recovered to the State so they don't even go to  
20 the taxpayer? But is the taxpayer saddled with that too?

21                   MR. SALMONS: Your Honor, I would think the  
22 answer to that question is no. It's not a question that I  
23 have examined in depth in -- in this case because it's not  
24 presented, but as a general matter --

25                   JUSTICE O'CONNOR: Well, what about attorney's

1 fees in class actions? As I understand it, those are not  
2 regarded by the Government as attributable all to the  
3 taxpayer.

4 MR. SALMONS: Your Honor --

5 JUSTICE O'CONNOR: A plaintiff who's part of a  
6 class in a class action suit where attorney's fees are  
7 paid.

8 MR. SALMONS: Your Honor, we believe that the  
9 same principles would apply to class action lawsuits as to  
10 other lawsuits in terms of the taxation of litigation  
11 proceeds. It may very well be the case in a number of  
12 class action contexts that when applying those principles,  
13 the proper -- the proper analysis leads to the conclusion  
14 that the taxpayer doesn't exert sufficient control and  
15 that the payment of attorney's fees is not in response to  
16 a debt owed by the taxpayer. And so there might be a  
17 different result.

18 JUSTICE O'CONNOR: Well, I -- I thought we were  
19 -- our attention was pointed to a number of instances  
20 where the Internal Revenue Service did not require the  
21 taxpayer to show all the attorney's fees as income in  
22 those class action situations.

23 MR. SALMONS: Your Honor, that is correct.

24 JUSTICE O'CONNOR: Yes.

25 MR. SALMONS: I want to be clear. We think the

1 same principles apply across the board to defining gross  
2 income. In applying that in a number of class action  
3 contexts, the proper answer may be that it's not included  
4 in gross income because there wasn't sufficient control  
5 and because it wasn't paid in -- in lieu of a debt owed by  
6 the taxpayer. But here --

7 JUSTICE SOUTER: Why -- why isn't there as much  
8 control in each case? I mean, the -- somebody goes to a  
9 lawyer with a claim and says, press the claim for me,  
10 recover if you can. What's the difference in -- in terms  
11 of control? So that if you win this case, why doesn't it  
12 apply to class action?

13 MR. SALMONS: Again, the principles would apply  
14 and there may very well be class actions --

15 JUSTICE SOUTER: Yes, and I -- I want to know  
16 why the result would be different.

17 MR. SALMONS: Again, I'm -- I'm trying to be as  
18 specific as I can. There may be situations in which, even  
19 in the class action context, there's a fee agreement  
20 between the -- the class member and the lawyer so that the  
21 payment of attorney's fees is in satisfaction of a debt  
22 owed by the class member, and in that situation we think  
23 that it would be --

24 JUSTICE SOUTER: Why -- why would -- why would  
25 that analysis appear? Certainly there's -- there's not

1 going to be any fee paid in the -- in the paradigm example  
2 of the class action without a recovery.

3 MR. SALMONS: That's correct, Your Honor. There  
4 -- there are situations --

5 JUSTICE SOUTER: So we're in the -- so we're in  
6 the situation we're in right now, aren't we?

7 MR. SALMONS: We are in the situation in which  
8 there's a need to apply the general principles for  
9 defining gross income.

10 JUSTICE SOUTER: All right. But let me just --  
11 I'll just press the point one more time. I don't  
12 understand, based on what you've said, why the class  
13 action result would be different from the result that  
14 you're arguing for here if you win this case.

15 MR. SALMONS: And -- and what I'm trying to  
16 point out, Your Honor, is that there may very well be  
17 class actions where it's not different. There may be some  
18 when -- where it is if it's the case that there's no  
19 contractual obligations to pay the fee -- pay the fee  
20 between the class member and the attorney, and if it's the  
21 case that the class member really exerts no meaningful  
22 control over the -- over the attorney's fees portion --

23 JUSTICE BREYER: I thought the class action  
24 distinction that the commissioner had was between opt in  
25 and opt out.

1           MR. SALMONS: That is certainly one of the  
2 factors that -- that the commissioner has looked to in  
3 those class --

4           JUSTICE BREYER: So if you opt in, then you did  
5 exercise control. So all the money is yours. But if you  
6 opt out, you didn't have control over the suit because you  
7 didn't opt out. I mean, you just were lethargic.

8           MR. SALMONS: Again, those are all facts --

9           JUSTICE BREYER: That's the basic thing. I  
10 mean, I'm trying to understand what the principle is for  
11 the reason that it's pretty hard for me to reconcile the  
12 commissioner's view in the class action case with the  
13 punitive damage case because there the person has control  
14 over the lawsuit. So why doesn't all the punitive damage,  
15 attorney's fees that come out of that, and so forth belong  
16 to -- in other words, it sounds to me, as I read this,  
17 something of a mess, and I'd like to know what the clear  
18 principle is.

19          MR. SALMONS: Yes, Your Honor. And -- and just  
20 to be clear, I -- I don't think the commissioner has ever  
21 taken the position that all class actions don't present  
22 the -- the possibility of the attorney's fees portion of  
23 the award being included in -- in the class member's gross  
24 income.

25          Now, there are real enforcement issues, as a

1 practical matter, to trying to -- to trying to implement  
2 that. You can imagine a number of class actions --

3 JUSTICE GINSBURG: When you say the class  
4 member, do you -- you mean the named representative. The  
5 class may include thousands of people, but it would be  
6 income to the named representative? Is that --

7 MR. SALMONS: Well, presumably, Your Honor, that  
8 -- only the portion of the attorney's fees that would be  
9 attributable to the -- the named representative's recovery  
10 would be included in the named representative's gross  
11 income. I don't think that the named representative would  
12 be on the hook, if you will, for all of the attorney's  
13 fees that would relate to other class members' recoveries.

14 But I think what all this points out is that --

15 JUSTICE GINSBURG: Well, then -- then would it  
16 be -- would the income then go to each class -- would each  
17 class member have a share of the income?

18 MR. SALMONS: In a number of instances, yes,  
19 Your Honor. Again, the -- the way that we think that  
20 class action cases should be resolved is the same way that  
21 -- that these issues are approached in all cases, which is  
22 to look at the type of relationship that exists between  
23 the -- the client and the attorney to see whether the  
24 payment is made in -- in response to a debt owed by the  
25 client and also to look to the degree of control that the

1 client has over the -- the underlying source of income.

2 And in this context, it is --

3 JUSTICE SCALIA: Suppose -- suppose the same  
4 amount were paid, as was paid here, to the attorney, but  
5 it was not by way of a contingent fee, that the -- the  
6 client had committed to pay this dollar amount in a dollar  
7 amount.

8 MR. SALMONS: As a flat fee?

9 JUSTICE SCALIA: As a flat fee. What -- what  
10 would the tax treatment of that be?

11 MR. SALMONS: Your Honor, I think in fact it is  
12 undisputed in -- in the -- in these cases that if the  
13 payment of attorney's fees had either been under an hourly  
14 rate arrangement or a flat fee arrangement, that the  
15 entire amount of the litigation proceeds would be included  
16 in the -- in the respondent's gross income and nothing  
17 about the contingent fee arrangements here should --  
18 should alter that result. The respondents --

19 JUSTICE O'CONNOR: Well, let -- let me ask you  
20 about Professor Davenport's theory. He filed a -- an  
21 amicus brief here saying that the contingency fee or the  
22 attorney's fees should be capitalized as a transaction  
23 cost increasing the basis of the property which was the  
24 claim in the lawsuit.

25 MR. SALMONS: Your Honor, I'm trying to recall

1     that amicus brief. I believe that -- was that an  
2     argument, I believe, about the application of section 83  
3     of the tax code when you have a transaction --

4             JUSTICE O'CONNOR: Yes.

5             MR. SALMONS: -- in exchange for services and  
6     you provide property?

7             JUSTICE O'CONNOR: Yes.

8             MR. SALMONS: We think that the better way to  
9     analyze this is that in fact there was no transfer of the  
10    underlying cause of action, and so we think that -- that  
11    we -- that gets into a very complicated area as to how you  
12    value the attorney's fees at the time.

13            JUSTICE SCALIA: Well, you -- you don't need a  
14    transfer of the -- I don't understand what you mean --

15            JUSTICE O'CONNOR: No, I don't either.

16            JUSTICE SCALIA: -- a transfer of the -- the  
17    cause of action. Certainly if you buy a piece of real  
18    estate and -- and there's lawyer's business connected with  
19    it, you -- you don't -- you don't take an ordinary  
20    deduction which is subject to the alternative minimum tax  
21    for those lawyer's fees. You just say that's part of the  
22    transaction, and it goes onto the basis of your property.  
23    Right?

24            MR. SALMONS: I believe that's correct, Your  
25    Honor. But the point I was making --

1 JUSTICE SCALIA: Why isn't -- why isn't that  
2 very similar to this? I mean, what difference does it  
3 make whether there's a -- there's a transaction here,  
4 isn't there? Isn't there a transaction?

5 MR. SALMONS: Well, there is an agreement to pay  
6 a fee for a service, and in that sense there is a  
7 transaction, yes.

8 JUSTICE SCALIA: Yes, but a -- the service is  
9 connected to a transaction, namely the conversion of the  
10 chosen action into a money payment. You have this --

11 MR. SALMONS: That -- that is correct.

12 JUSTICE SCALIA: -- this unformed chosen action.  
13 You're entitled to it, but there's a transaction  
14 converting it into a money payment. Now, why shouldn't  
15 you attribute to that transaction all -- which is  
16 profitable to you, all of the costs that go along with the  
17 transaction?

18 MR. SALMONS: Well, again, Your Honor, we think  
19 that transaction is essentially identical to numerous  
20 transactions that take place every day out in the real  
21 world where -- where taxpayers retain professional  
22 services in exchange for a commission or a percentage of  
23 the income that's generated.

24 JUSTICE SCALIA: That is a problem that occurs  
25 to me. I don't know where you draw the line. And you say

1     you can't draw a line.

2                 MR. SALMONS: That is absolutely correct. I  
3     don't see any basis for distinguishing between --

4                 JUSTICE GINSBURG: How does it work?

5                 MR. SALMONS: -- the attorneys here and -- and a  
6     -- and an agent negotiating a book contract for an author  
7     or a financial analyst.

8                 JUSTICE GINSBURG: You -- on that, that example,  
9     you gave the book contract with the author and you gave, I  
10    think, the investor. Would this problem arise in those  
11    cases or would the author get an above-the-line deduction?

12                MR. SALMONS: No, Your Honor. I believe that  
13    the author in those -- in that situation would receive the  
14    same deduction that prior to the enactment of section 703  
15    of the American Jobs Creation Act where Congress just  
16    addressed in part the -- the issue raised in these  
17    cases --

18                JUSTICE GINSBURG: So you say the author -- that  
19    these people are all in the same --

20                MR. SALMONS: They would have an itemized --  
21    excuse me -- a miscellaneous itemized deduction for the  
22    cost incurred in -- in producing income that under the  
23    alternative minimum tax would not be allowed.

24                JUSTICE KENNEDY: Is there any argument -- you  
25    -- you said at the outset that it has to be an itemized

1 deduction subject to the 2 percent rule even if we set  
2 aside the alternative minimum tax. Is that conceded by  
3 everyone, or does somebody -- do some people say this is  
4 an ordinary and necessary expense? I know it's not your  
5 business, but it seems to me an ordinary and necessary  
6 expense to recover the -- the -- for employment  
7 discrimination, which is really part of your work. I  
8 don't know why -- is it -- does everybody agree that this  
9 is subject to the 2 percent rule?

10 MR. SALMONS: I will -- I will have to allow  
11 respondents to speak for themselves to that question, but  
12 as far as I'm aware, that is not in dispute in these cases  
13 or in any of the cases that have been litigated that --  
14 that but -- that but for the alternative minimum tax, the  
15 way this would have been handled is that there would have  
16 been a miscellaneous itemized deduction under section 212  
17 of the code for the cost incurred in producing income, and  
18 that the alternative minimum tax, along with, by the way,  
19 a large number of other perfectly valid deductions, get  
20 disallowed under the alternative minimum tax.

21 JUSTICE KENNEDY: I -- I can't get out of my  
22 mind in this case that the mechanics of the particular  
23 case may control. I know we need a national rule and so  
24 forth. My recollection is that in some States when there  
25 is a settlement or a judgment paid under a case where

1     there's a contingency fee contract, the check is made out  
2     both to the attorney and to the client and is put in the  
3     attorney's client's trust account. So the client never  
4     has control over it.

5             MR. SALMONS: Well --

6             JUSTICE KENNEDY: Let's assume that that's true  
7     in most of the States.

8             MR. SALMONS: That -- that -- I know that were  
9     -- that was the facts, Your Honor, in the -- in the Banks  
10    case, that there was a check made out to both. In fact --  
11    in fact, there was --

12            JUSTICE KENNEDY: So in a very real -- in -- in  
13    a very real sense, in a -- in the legal sense, the client  
14    just doesn't have control.

15            MR. SALMONS: Well, Your Honor, we disagree with  
16    that for, it seems to me, at least three reasons. The  
17    first is that at the time the client entered into the fee  
18    agreement, he certainly had control then. He had complete  
19    control over his cause of action. He was --

20            JUSTICE KENNEDY: Well, he -- he did or he  
21    didn't, but there was no money there. There was nothing  
22    there.

23            MR. SALMONS: Well, there was an entitlement to  
24    recover. Now, there might have been a dispute as to the  
25    proper amount or whether that claim was valid, but he was

1 entitled to recover based on the injury he suffered that  
2 was cognizable at law and that gave raise to a cause of  
3 action.

4 Now, in exchange for legal services, he promised  
5 to pay a portion of the recovery to the lawyer. That is a  
6 promise to pay a fee. That is not an assignment or any  
7 other transfer of the underlying cause of action. And it  
8 is undisputed, I think --

9 JUSTICE SOUTER: Mr. Salmons, doesn't the  
10 plausibility of your argument here rest on the assumption  
11 that what the -- that the cause of action at the time the  
12 -- that the plaintiff made the agreement with the lawyer  
13 is a cause of action which has the same value as the  
14 ultimate recovery that the lawyer gets? Whereas, in fact,  
15 the cause of action at the time of the agreement with the  
16 lawyer has an inchoate value. The -- the value that is  
17 actually realized is going to depend in part on the -- on  
18 the skill and -- and the -- the gumption of the lawyer.

19 So that the -- what I'm getting at -- and -- and  
20 going to Justice Kennedy's question, it seems to me that  
21 the value realized as opposed to the right to sue are two  
22 different figures. And I don't see realistically how the  
23 client has complete control over the value realized, which  
24 we don't even know until the lawyer has done his work and  
25 gotten the check.

1                   MR. SALMONS: Your Honor, two responses to that  
2 question, if I may. The first is that, as a matter of  
3 law, it is the client that controls the cause of action  
4 and throughout the time period, even after they -- they  
5 enter into an -- a contingent fee agreement, it is the  
6 client that owns and controls the cause of action and he  
7 decides whether to settle. He decides whether to press  
8 forward or withdraw the case. He decides whether to fire  
9 the lawyer or not. He is a -- he controls the source of  
10 the income. Therefore --

11                   JUSTICE GINSBURG: Even -- even the potential  
12 lawyer's fee. I mean, suppose this client has a major  
13 dental repair and he's got a risk-taking dentist, and he  
14 says, dentist, I'm going to give you a deal. I know you  
15 like to take risks. I may win big in my lawsuit, in which  
16 case you get everything; and I may lose, in which case you  
17 get nothing. The dentist says, fine, I'll take it. Can  
18 the client in that agreement with his dentist give what  
19 will be the lawyer's fee, the part that will go to the  
20 lawyer under the contingency fee agreement?

21                   MR. SALMONS: Well, presumably, Your Honor, if  
22 he's already -- he's already promised that to the  
23 attorney, he would be in violation of his agreement with  
24 the attorney if he did so, and his attorney could sue him  
25 to recover or the dentist could sue him to recover.

1 JUSTICE GINSBURG: Then he doesn't have -- then  
2 he doesn't have dominion over that portion.

3 MR. SALMONS: Well, because he's -- he's given  
4 it away. In that sense I think -- and -- and in answering  
5 this, if I may just go back to one point that Justice  
6 Souter made and that is that I don't think it's the case  
7 that our analysis turns at all on how you value the claim,  
8 either at the time of the fee agreement or afterwards.  
9 Our analysis says at all relevant times, regardless of  
10 whether the value changed or not, the client was at all  
11 times in control of the underlying source of income, and  
12 it's just as if in Helvering v. Horst the father assigns  
13 the -- the bond coupon to his son, but he controls the  
14 underlying source of income.

15 JUSTICE SOUTER: No, but the bond coupon has a  
16 certain value at the time the father assigns it.

17 MR. SALMONS: That's true.

18 JUSTICE SOUTER: The only thing that has to be  
19 realized after the assignment of the coupon is the passage  
20 of time at which it will be payable. Here we do not have  
21 a definite value. We don't know -- there's no way to know  
22 for sure what the value will be until the lawsuit is over  
23 with. The -- the two are not comparable.

24 MR. SALMONS: Your Honor, that would be equally  
25 true of an assignment of a stock dividend while I retain

1 the stock. I may not know what the dividend payment is  
2 going to be, but if I control the underlying source of  
3 income, i.e., the stock, then the transfer to someone else  
4 of the dividend doesn't alter the incident of tax, even if  
5 it's unknown.

6 And I would point out that in *Lucas v. Earl*, the  
7 husband and wife in that case entered into agreement to  
8 assign to each other 50 percent of their income in 1901,  
9 long before the income tax was even instituted, and the  
10 tax years at issue in that case were 1920 and 1921. If  
11 anything, it was much more speculative and uncertain what  
12 income would have been earned 20 years later in that case,  
13 and that did not stop the Court from --

14 JUSTICE BREYER: So you're -- you're --

15 MR. SALMONS: -- applying this principle that --

16 JUSTICE SCALIA: Can I -- can I ask you a  
17 question relating to the *Davenport* -- what's been referred  
18 to as the *Davenport* theory? I had thought that -- that  
19 the service has used the -- the transaction theory with  
20 regard to legal fees payable for a lawsuit seeking  
21 increased compensation for the condemnation of real estate  
22 where the taxpayer had objected to the amount that the  
23 condemning entity was offering and brought suit in court  
24 and with a contingent fee to the lawyer and that the  
25 service treated that as -- as part of the transaction

1 cost. Am I wrong about that?

2 MR. SALMONS: Your Honor, to my knowledge, the  
3 -- the IRS has had a consistent position that the entire  
4 amount of litigation proceeds, including the amount that  
5 may be paid to a lawyer under a contingent fee agreement,  
6 even in the condemnation context, is -- is included in the  
7 gross income of -- of the taxpayer.

8 And I would point Your Honor to the case out of  
9 the Federal Circuit, Baylin v. United States. That case  
10 involved a condemnation action, and the court of appeals  
11 in that case addressed the issue that's presented in these  
12 cases and concluded that it was includable in gross  
13 income.

14 JUSTICE SCALIA: Maybe my recollection is wrong.  
15 I'll look again.

16 MR. SALMONS: And -- and I would point out, Your  
17 Honor -- and this has to do, I think, with the impact of  
18 the new legislation that's been pointed to in the  
19 supplemental briefs -- that at least six of the court of  
20 appeals cases addressing the issue presented in these  
21 cases involved claims that would not be covered under the  
22 new section 703 because they -- they don't involve claims  
23 for unlawful discrimination or -- or FCA claims or certain  
24 Medicare claims --

25 JUSTICE BREYER: But can -- can I ask you to go

1 back for a minute? I guess the IRS -- you're seeing the  
2 lawsuit as the income-generating asset.

3 MR. SALMONS: That's correct, Your Honor.

4 JUSTICE BREYER: And you're looking at the  
5 control of the plaintiff, for example, over the lawsuit as  
6 something that determines whether it's his income. And  
7 he, of course, can't give away his income. But on that  
8 theory, to go back to Justice O'Connor's original  
9 question, then the punitive damages also must be his  
10 income because he has equal control over them and they  
11 grow out of the income-producing asset. And that, of  
12 course, is what's bothering me because it seems to me that  
13 your theory, which is a well-established theory, coupled  
14 with a Congress that seems to be willing to take away  
15 deductions for expenses that lead to the income, could  
16 produce an income tax that in many cases, not just a few,  
17 exceeds the income that an individual has. And I would  
18 like to know what in the law is there to guard against  
19 that result.

20 MR. SALMONS: Well, Your Honor, I guess my  
21 response to that is that, first --

22 JUSTICE KENNEDY: Other -- other than the mercy  
23 of the Internal Revenue Service.

24 (Laughter.)

25 MR. SALMONS: Your Honor, the fact of the matter

1 is, is that Congress has looked at -- at this issue, and  
2 in the new section that I just referred to, section 703 --

3 JUSTICE O'CONNOR: Well, but does that happen?  
4 You haven't the question. Are there instances where  
5 plaintiffs in lawsuits end up receiving tax bills, as a  
6 result of this scheme, for more money than they received  
7 in the lawsuit?

8 MR. SALMONS: That has occurred, Your Honor.

9 JUSTICE O'CONNOR: Yes.

10 MR. SALMONS: And -- and Congress responded to  
11 concerns about that very result --

12 JUSTICE KENNEDY: Well, but doesn't -- doesn't  
13 that indicate --

14 MR. SALMONS: -- in the new section.

15 JUSTICE KENNEDY: -- something basically flawed  
16 about your whole theory?

17 MR. SALMONS: No, Your Honor. It is --

18 JUSTICE KENNEDY: This is not income in any --  
19 in any real sense.

20 JUSTICE BREYER: Is there any constitutional  
21 protection? The Sixteenth Amendment refers to an income  
22 tax, and perhaps that doesn't include a tax that grossly  
23 exceeds in many cases a person's income. That would be  
24 quite a far-out theory at the moment.

25 MR. SALMONS: I think it would be, Your Honor.

1 JUSTICE BREYER: But I -- that's why I ask you.  
2 Is there any protection in the law whatsoever? Or if  
3 Congress decides to tax a set of people who, let's see --  
4 say, earn \$10,000 a year and because they're small  
5 business people, they happen to have \$20,000 expenses. So  
6 it taxes them on \$20,000, and the tax exceeds the income.  
7 There's no protection in your view against that result.  
8 And you just said, well, Congress decided to do it, it  
9 decided to do it.

10 MR. SALMONS: But we do think, Your Honor, that  
11 the only limit on Congress' taxing authority would be the  
12 Constitution, and I don't see a constitutional violation  
13 in disallowing a deduction, but --

14 JUSTICE BREYER: What about an assumption, for  
15 example, that when we read the code, we read it with a  
16 view towards thinking Congress did not want to produce  
17 such unfair results?

18 MR. SALMONS: Your Honor, if I may. The way I  
19 would respond to that concern is that the proper way to  
20 address it is not as the courts below did and as  
21 respondents urge, to alter or distort the general  
22 definition for gross income under the -- under the tax  
23 code which may have broad ramifications in a number of  
24 areas outside of this one, but to go to Congress, as in  
25 fact people have done, and to get them to make -- make

1 additional deductions or otherwise alter the alternative  
2 minimum tax, which generates the primary concern I think  
3 at issue in these cases.

4 JUSTICE GINSBURG: What happened in the cases --

5 MR. SALMONS: That's the proper way to handle  
6 that.

7 JUSTICE GINSBURG: There were cases -- we don't  
8 have to deal in hypotheticals. There were cases where  
9 this happened, where people ended up liable for a tax  
10 greater than what they took in. What happened in those  
11 cases?

12 MR. SALMONS: They were -- they were liable for  
13 a tax greater than what they took in. Those were pointed  
14 to Congress --

15 JUSTICE GINSBURG: I mean, there was one that  
16 was \$99,000, if I remember right.

17 MR. SALMONS: I believe that's correct. Those  
18 were pointed out to Congress and that was part of what  
19 motivated Congress --

20 JUSTICE GINSBURG: Was there a private bill?

21 MR. SALMONS: -- to enact section 703 to  
22 protect --

23 JUSTICE GINSBURG: Or what happened? What  
24 actually happened in that case, do you know?

25 MR. SALMONS: I do not know, Your Honor. My --

1 my understanding is that the tax was assessed and I don't  
2 know whether --

3 JUSTICE SCALIA: Mr. Salmons, I -- I -- you've  
4 cited the -- the Baylin case to me and I -- I've looked at  
5 the description of it in the brief, which I had recalled,  
6 and what it says is that it did, indeed, involve a taking  
7 by the State, and when the State didn't offer what Baylin  
8 thought was -- was enough, he went to court, he prevailed,  
9 and recovered a much larger sum than the State had offered  
10 him. His legal fees were, by the IRS, subtracted from the  
11 award, and he was taxed only upon the proceeds reduced by  
12 the legal fees. Now, how do you explain that situation  
13 there?

14 MR. SALMONS: Your Honor, if I --

15 JUSTICE SCALIA: And how does that --

16 MR. SALMONS: -- misremembered that case, I  
17 apologize. My -- my recollection was that -- was that the  
18 court in that case had included the attorney's fees in  
19 gross income. But -- but --

20 JUSTICE SCALIA: I doubt -- I doubt whether  
21 Professor Davenport has misdescribed the case in -- in his  
22 brief, but I --

23 MR. SALMONS: But -- but again, Your Honor, if I  
24 may. I think the -- the basic point to recall here is  
25 that the definition of gross income cuts across the tax

1 code. If there are concerns about application, then the  
2 proper result is to go to Congress, as has been done.  
3 Congress has addressed the very concerns cited by  
4 respondents and the amici in this case, and that  
5 specifically is the -- the application on civil rights  
6 plaintiffs.

7 JUSTICE O'CONNOR: Does the Fifth Amendment  
8 Takings Clause apply to a Government tax scheme that taxes  
9 something beyond the income received?

10 MR. SALMONS: Your Honor, it -- there may be --  
11 there may be a takings issue at some point. Again, there  
12 may be constitutional limitations.

13 JUSTICE O'CONNOR: Well, at the point where the  
14 Government charges more than the taxpayer received --

15 MR. SALMONS: But I think, Your --

16 JUSTICE O'CONNOR: -- in income?

17 MR. SALMONS: Your Honor, I think when -- when  
18 what you're talking about is how to define --

19 JUSTICE O'CONNOR: I mean, this is an appalling  
20 situation.

21 MR. SALMONS: Again, Your Honor, I -- I think as  
22 a general matter, the -- the proper definition of gross  
23 income would include the attorney's fees portion of  
24 litigation awards. It's important to note that the when  
25 Congress --

1 JUSTICE SOUTER: What -- what do you we make of  
2 the fact that two Senators apparently don't agree with  
3 that position? I mean, I -- I'm referring to the colloquy  
4 that was quoted in -- in one of the -- the briefs about  
5 the recent legislation, and the -- the substance of the  
6 colloquy was we're not making any change in the law, we're  
7 just clarifying it. Well, in fact, if there is no textual  
8 difference for tax purposes between the law, so far as it  
9 concerns these -- these so-called discrimination  
10 recoveries and non-discrimination recoveries that have the  
11 same problem that Justice O'Connor is talking about,  
12 shouldn't we infer that at least the Senate of the United  
13 States assumes that this does not get into gross?

14 MR. SALMONS: No, Your Honor. In fact, what I  
15 would say is that the thing to focus on is what Congress  
16 actually enacted and it makes clear that all the  
17 litigation proceeds --

18 JUSTICE SOUTER: I'm -- I'm talking about the  
19 colloquy. I'm talking about the colloquy.

20 MR. SALMONS: I -- I understand that, Your  
21 Honor, and what I'm trying to answer is that the -- the  
22 legislation itself makes clear that it's included in gross  
23 income and an above-the-line deduction is provided, and  
24 that the colloquy was referring to a prior version of the  
25 bill that would have been retroactive in part. The new

1 bill is not retroactive, and we think it's clear that it  
2 does work a change because from, among other reasons, it's  
3 undisputed that if these fees had been paid on an hourly  
4 fee basis, they would have been included in gross income  
5 and -- and the alternative minimum tax would apply.

6 JUSTICE SCALIA: We don't really know who  
7 prepared that colloquy anyway, do we?

8 MR. SALMONS: We do not.

9 JUSTICE SCALIA: It might have been prepared by  
10 the respondents here.

11 MR. SALMONS: We do not.

12 (Laughter.)

13 MR. SALMONS: If I may reserve the remainder of  
14 my time.

15 JUSTICE STEVENS: Mr. Jones.

16 ORAL ARGUMENT OF PHILIP N. JONES

17 ON BEHALF OF RESPONDENT BANAITIS

18 MR. JONES: Thank you, Justice Stevens, and may  
19 it please the Court:

20 My client and I are asking the Court to rule  
21 that the assignment of income doctrine does not apply when  
22 unrelated persons combine their resources to jointly  
23 generate income. And we --

24 JUSTICE KENNEDY: What -- so what -- what about  
25 the talent scout who tells the celebrity that he'll take

1 10 percent of the celebrity's movie proceeds or the  
2 management search person that's going to take a -- a third  
3 of the executive's pay for the first 6 months? Where --  
4 are all -- all these cases ones in which there -- there's  
5 no income to the -- to the principal, we'll call them?

6 MR. JONES: You mentioned the -- the management  
7 agent and the -- I think you mentioned the talent agent,  
8 and there was also mentioned the literary agent. The --  
9 the author is in the trade or business and gets to deduct  
10 all this off the top. There's no problem there.

11 JUSTICE GINSBURG: That's the -- that's the  
12 question I asked Mr. Salmons --

13 MR. JONES: Yes. The literary agent --

14 JUSTICE GINSBURG: -- and he gave me the  
15 opposite answer.

16 MR. JONES: Yes. The literary agent is in a  
17 trade or business. That's off the top. That's an  
18 ordinary and necessary business deduction on Schedule C.

19 JUSTICE BREYER: And that isn't the question.

20 MR. JONES: Yes.

21 JUSTICE BREYER: The -- the problem is you're --  
22 you're trying to get a theory in response to him that I  
23 think Justice Kennedy is asking about.

24 MR. JONES: Yes.

25 JUSTICE BREYER: And that theory, which is the

1 problem for your side of the case -- that theory has all  
2 kinds of implications. I go out and I help the painter  
3 paint my office. We have a joint venture. I -- so  
4 there's no problem. I don't take it in -- you know, I get  
5 a -- this is great. And so that I think, if I'm right,  
6 was the thrust of Justice Kennedy's question.

7 MR. JONES: Our first choice, our preference for  
8 this Court to rule is -- is not the partnership or joint  
9 venture theory. Our first choice is for this Court to  
10 simply look at the application of the assignment of income  
11 doctrine and ask it -- if it is being misapplied. The --  
12 the petitioner has not cited to the Court a single,  
13 solitary case in which unrelated persons combine their  
14 resources to jointly produce income, and that is the rule  
15 of law I'm suggesting to the Court today. That is apart  
16 and separate from the partnership theory, that two  
17 unrelated persons who join together to produce income --

18 JUSTICE SCALIA: It's a partnership theory when  
19 you talk about two persons joining together. I don't like  
20 this -- this gold mine view of litigation, that it's, you  
21 know, like two prospectors. You know, there's money to be  
22 obtained.

23 (Laughter.)

24 MR. JONES: I --

25 JUSTICE SCALIA: That's -- that's not what I

1 view of a chosen action as. I view it as a legal right --

2 MR. JONES: Yes.

3 JUSTICE SCALIA: -- that the person is entitled  
4 to money, and ultimately the amount he's entitled to is  
5 determined by the litigation. And I'm not about to adopt  
6 a -- a legal theory that -- that views this as a -- as a  
7 search for buried treasure --

8 (Laughter.)

9 JUSTICE SCALIA: -- in -- in which the -- the  
10 lawyer and the person who has been wronged are -- are  
11 simply co-prospectors. I -- I just think that that's --

12 MR. JONES: Well, the --

13 JUSTICE SCALIA: Maybe that's how you view the  
14 -- the enterprise --

15 MR. JONES: I would like to --

16 JUSTICE SCALIA: -- but I don't think the law  
17 does.

18 MR. JONES: I would like to suggest to the Court  
19 three avenues to reach this result that I have just  
20 suggested and the partnership/joint venture theory is only  
21 one of those.

22 JUSTICE O'CONNOR: Well, let's move on to  
23 something else because I have a couple --

24 (Laughter.)

25 MR. JONES: Okay. I will move on to that, and I

1 will not mention that again.

2 (Laughter.)

3 MR. JONES: This Court created the assignment of  
4 income doctrine. Congress did not create it. This Court  
5 has every right and power to limit its -- its definition,  
6 to limit its scope to keep it from being misapplied. In  
7 every case cited by the petitioner, we have a -- a family  
8 situation, related people making gifts to each other with  
9 no commercial purpose. Apart from the partnership and  
10 joint venture theory, if we simply say that this case is  
11 dramatically outside of the scope of that doctrine, of  
12 good doctrine that has been applied properly in an inter-  
13 family situation, but when you have two unrelated persons  
14 joining forces to produce income --

15 JUSTICE STEVENS: Would you have a different  
16 result if they were related? Supposing the lawyer is a  
17 cousin of the client.

18 MR. JONES: This Court has a long history of  
19 recognizing --

20 JUSTICE STEVENS: Or a good friend.

21 MR. JONES: -- of recognizing sham transactions.

22 JUSTICE STEVENS: Well, it's not a sham  
23 transaction. You just happen to be related.

24 MR. JONES: All right.

25 JUSTICE STEVENS: And I'm just wondering if

1     that --

2                   MR. JONES:  I would like to focus on the  
3     gratuitous nature of the cases relied upon by the  
4     petitioner and the non-gratuitous aspects of our case.  
5     Let's talk about a person injury case where this problem  
6     does not arise because there's no tax involved.  This  
7     relationship of a contingent fee is entered into thousands  
8     of times every week by people injured in automobile  
9     accidents.  They are not entering into this contingent fee  
10    agreement for tax purposes.  They're not trying to avoid  
11    tax -- taxes.  The commissioner is confusing intent  
12    with --

13                  JUSTICE SOUTER:  All right.  On -- on that  
14    theory, that there is a non-tax economic purpose, do you  
15    still maintain that your theory should have as an element  
16    unrelated people?

17                  MR. JONES:  I --

18                  JUSTICE SOUTER:  Why do we need the question of  
19    the relationship, which Justice Stevens's questions  
20    raised, even to arise if -- if the principal criterion is  
21    going to be economic non-tax purpose?

22                  MR. JONES:  I agree completely.  I was trying to  
23    emphasize the -- the intrafamily gratuitous nature of  
24    those cases, but I agree --

25                  JUSTICE SCALIA:  There was no avoidance motive

1 in the --

2 MR. JONES: Yes.

3 JUSTICE SCALIA: -- granddaddy of all cases.

4 The assignment there, although it was between family  
5 members, had been made before there was an income tax.

6 MR. JONES: But we must --

7 JUSTICE SCALIA: The income tax didn't exist.  
8 There -- there couldn't conceivably have been an avoidance  
9 motive. So -- so our holding could hardly be based upon  
10 -- upon the existence of an avoidance motive.

11 MR. JONES: I'm asking the Court to skip over  
12 motive and look at result. The Court in that case was  
13 attacking a result because that arrangement stayed in  
14 place after the income tax was -- was enacted. The  
15 Solicitor General is confusing intent with result. In  
16 every case, in every single case, without exception, this  
17 doctrine has been applied to the result.

18 JUSTICE STEVENS: Yes, but what if you had the  
19 same result but -- in terms of the sharing of the expense  
20 and the recovery, but it was computed on an hourly basis  
21 rather than a percentage basis? Would that produce a  
22 different result?

23 MR. JONES: It would produce a different result.  
24 The commissioner's case is based on could have. They say  
25 they could have tried the case himself. He couldn't. But

1 -- but the main thing he --

2 JUSTICE STEVENS: No, but he could have made --

3 I'm saying he could have said to the lawyer, I'll pay you

4 30 -- a -- a third of the recovery or I'll pay you \$100 an

5 hour.

6 MR. JONES: Well, he --

7 JUSTICE STEVENS: And they come out exactly the

8 same result, but you -- but do you treat them differently

9 or the same?

10 MR. JONES: We treat them differently simply

11 because he didn't. I practice law in a partnership. I'm

12 taxed accordingly. I could -- I could be -- set up my

13 arrangement different ways and the tax results would be

14 different. We must honor these relationships --

15 JUSTICE SCALIA: What is different?

16 JUSTICE STEVENS: Well, may I ask one --

17 JUSTICE SCALIA: What is different?

18 JUSTICE STEVENS: May I ask one other

19 hypothetical? Supposing that the agreement on the

20 contingency is postponed until the middle of the

21 preparation, not made at the outset, but along the line,

22 they say we'll figure out what a fair percentage will be,

23 and when the recovery comes in, they then decide, okay,

24 you take a third. What -- what result do you do in that

25 case?

1                   MR. JONES: I -- I have difficulty with that  
2 question.

3                   JUSTICE STEVENS: But I'm sure it arises fairly  
4 often.

5                   MR. JONES: My -- I believe that attorneys don't  
6 allow themselves to be placed in that position. They get  
7 the contingent fee agreement signed when the -- the --

8                   JUSTICE STEVENS: Well, I did very often.

9                   MR. JONES: But I don't know the answer to your  
10 question. I -- I don't know that.

11                   But an -- we -- the Internal Revenue Code  
12 respects people who enter into corporations, who enter  
13 into joint ventures, who enter into sole proprietorships,  
14 who hire employees or allow themselves to be hired by  
15 others. Those relationships are all respected and honored  
16 by the Internal Revenue Code, and the commissioner is  
17 asking you to dishonor this relationship because Mr.  
18 Banaitis could have handled the case himself or could --

19                   JUSTICE KENNEDY: I think probably what's --  
20 what's one of the problems here is that the reason this is  
21 income is it relates to employment. And I don't see why  
22 hiring the attorney to get that income is not an ordinary  
23 and necessary business expense under what used to be  
24 section 162. That may be part of the problem. Do you  
25 agree that it's not an ordinary and necessary business

1 expense?

2 MR. JONES: I believe the problem is that a  
3 plaintiff has -- I wish I could say this plaintiff is in  
4 -- engaged in a trade or business and can deduct it or  
5 trade or -- as a trade or business expense.

6 JUSTICE KENNEDY: I mean, I suppose that's the  
7 reason -- that's the reason why it's taxable to begin  
8 with, is it relates to employment. If I hire an attorney  
9 because I'm wrongfully discharged and I get -- I get my  
10 job back, it seems to me that's an ordinary and necessary  
11 business expense. That -- that's why -- one of the  
12 reasons I have problems with this.

13 MR. JONES: I understand. But one of the -- the  
14 odd result here of a person having to pay more in taxes  
15 than they recover -- this actually comes up under a fee  
16 shifting statute that applies to the Internal Revenue  
17 Service where a person could be in litigation with the  
18 Internal Revenue Service, the Internal Revenue Service  
19 becomes obligated to pay fees because they acted  
20 unreasonably. They pay those fees, and then they  
21 simultaneously hand the taxpayer a bill for taxes on those  
22 fees.

23 JUSTICE KENNEDY: Well, let me get -- get to a  
24 different point. It -- it does seem to me that we -- we  
25 have to be very careful in this case not to distort the

1 revenue law for other transactions that are not before the  
2 Court. And the -- the natural extension of -- of your  
3 position is that anytime when the taxpayer enters into an  
4 agreement with an agent to pay the agents an amount  
5 contingent on the success of the venture, that it's not  
6 income, that -- that the -- that the payment is not income  
7 to the principal. And I just can't accept it.

8 MR. JONES: No. That is not my position. My  
9 position is that the assignment of income doctrine does  
10 not apply. Those relationships are all governed by  
11 existing law and there is a large body of law dealing with  
12 those cases and they can be found in a cite that is  
13 offered by the petitioner at page 3 of his reply brief.  
14 It talks about the literary agents. It talks about the --  
15 the management agents.

16 JUSTICE KENNEDY: But what's the difference in  
17 principle. I don't understand the difference in principle  
18 when we're talking about who has the income. It's the  
19 first thing you ask in -- in a first-year -- in -- in your  
20 -- in your first class in tax. Where is the income? Who  
21 gets the income?

22 MR. JONES: I -- I am not trying to avoid your  
23 question, but I'm trying to clarify that I am not asking  
24 this Court to determine who has the income in those cases  
25 because there is a large body of law and a large body of

1 statutory law that answers the questions for each of those  
2 examples. All I'm suggesting is that we do not get to  
3 those answers. We should not get to those answers through  
4 the assignment of income doctrine.

5 JUSTICE BREYER: What's your third? I just  
6 don't want you to miss your third. You have the joint  
7 venture theory, an exception to an assignment in income,  
8 and you said you had a third.

9 MR. JONES: The Oregon question, Your Honor,  
10 which I don't think the Court is likely interested in --

11 JUSTICE SCALIA: The who?

12 MR. JONES: The -- the Oregon question.

13 JUSTICE SCALIA: The Oregon question.

14 MR. JONES: The Oregon question. That is --

15 JUSTICE SCALIA: What is the Oregon question?

16 MR. JONES: The Oregon question is part IV of  
17 our brief beginning on page 31 which would not be a  
18 national uniform rule. But what we're asking this Court  
19 to do is simply, as narrowly as possible, to limit the  
20 assignment of income doctrine and do nothing more than  
21 that.

22 JUSTICE O'CONNOR: Well, what do you make of  
23 Professor Davenport's proposal to capitalize the  
24 contingency fee as a transaction?

25 MR. JONES: I believe Professor Davenport is

1 completely correct. I support his theory wholeheartedly.  
2 We didn't make that argument because we believe the  
3 limitation on the assignment of income doctrine is the  
4 real issue and we believe that is the narrower issue.

5 JUSTICE BREYER: Well, if you took a settlement  
6 -- his theory, I take it, was seeing the lawsuit as a  
7 capital asset. Is that right?

8 MR. JONES: Yes. Well, I -- I think so.

9 JUSTICE BREYER: Well, then whenever you settled  
10 a lawsuit, it would be -- you'd have to pay capital gains  
11 instead of ordinary income.

12 MR. JONES: I -- I'm sorry. I think I misspoke.  
13 I'm not sure that's his theory. I'm not certain, and  
14 I'm --

15 JUSTICE SCALIA: I'm sure it's not his theory.  
16 He -- he thinks it's -- it's attached to transactions, and  
17 -- and much of his argument is devoted to showing that  
18 capital transactions are no different from other  
19 transactions as far as the Internal Revenue Code's desire  
20 to match the -- the gain with the expenses concerned. And  
21 that's the part of his theory that I'm not so sure about  
22 because aside from the -- aside from the condemnation case  
23 that I mentioned, I -- I don't know of any other cases in  
24 which the Internal Revenue Service has treated transaction  
25 costs the way he would have it done. Maybe it makes

1 sense, but I --

2 MR. JONES: I would like to make one additional  
3 point in the few seconds I have left. The -- the  
4 Solicitor General is arguing that the language, the  
5 statutory language, of the new statute implies a  
6 particular result. This Court decided as early as 1940 in  
7 the Higgins v. Smith case when the commissioner made the  
8 exact same argument, and this Court said -- and I quote --  
9 that does not follow. The statutory language says that to  
10 the extent this income is -- this -- this money is  
11 included in income, to the extent it is included in income  
12 -- it doesn't say whether it is or not -- then a deduction  
13 will be allowed. And that as neutral a statement as I can  
14 think of. There is nothing in the statutory language that  
15 implies one answer or the other.

16 But I emphasize to the Court that the -- the  
17 commissioner is confusing intent with result when he  
18 discusses the cases upon which he is relying. Those cases  
19 reached a result and they corrected that result. We don't  
20 have an abuse in this situation. And the assignment of  
21 income doctrine should not be stretched beyond its bounds  
22 by this Court. It should be limited to its historical  
23 use. This is a misuse.

24 Thank you very much.

25 JUSTICE STEVENS: Thank you, Mr. Jones.

1                   Mr. Carty.

2                   ORAL ARGUMENT OF JAMES R. CARTY

3                   ON BEHALF OF RESPONDENT BANKS

4                   MR. CARTY: Thank you, Justice Stevens.

5                   Neither section 61(a) nor any other provision of  
6 the Internal Revenue Code expressly requires that a  
7 Federal civil rights litigant, such as Mr. Banks, include  
8 in his gross income the portion of a litigation recovery  
9 that was earned by, retained by, and already taxed to his  
10 attorney as a contingent fee.

11                  The commissioner's position in this case relies  
12 exclusively on the misapplication of a judicial doctrine  
13 known as the assignment of income doctrine. That doctrine  
14 originated and developed as a judicial anti-abuse rule,  
15 designed to prevent high-bracket taxpayers --

16                  JUSTICE SCALIA: No, it didn't.

17                  MR. CARTY: I respectfully --

18                  JUSTICE SCALIA: It -- it originated in a case  
19 where there could not possibly have been an -- an intent  
20 to abuse because the -- the transfer had occurred before  
21 there was any income tax.

22                  MR. CARTY: Justice --

23                  JUSTICE SCALIA: I mean, just -- just don't --  
24 maybe you think that that's what it ought to be, but --  
25 but please don't tell us that that is how it originated.

1 It plainly did not originate that way.

2 MR. CARTY: Justice Scalia, I respectfully  
3 disagree. It is true, as the commissioner and you point  
4 out, that at the time of the agreement between the husband  
5 and wife, the income tax was not in existence. However,  
6 the agreement certainly was in existence after the income  
7 tax was passed. So that could have been a reason why the  
8 agreement was never rescinded.

9 In addition, in another landmark case from 1937,  
10 Blair, this Court expressly looked to whether there was a  
11 tax avoidance motive. And this is how this principle is  
12 taught in first-year tax class. That's the whole purpose  
13 behind this. As a matter of fact, the commissioner in a  
14 -- in a different context actually looked to the fact,  
15 with respect to a particular transaction, whether there  
16 was as tax avoidance purpose.

17 JUSTICE SCALIA: That's a different argument.  
18 I'm -- I'm just quarreling over whether it originated that  
19 way. If you want to say --

20 JUSTICE KENNEDY: Under -- under your view --

21 JUSTICE SCALIA: -- that's fine.

22 JUSTICE KENNEDY: -- suppose that the attorney  
23 is -- is waiting for payment of -- of his, say, one-third  
24 contingency, and the client just absconds with the money.  
25 How is -- what -- what happens from a tax standpoint under

1 your theory? I take it the attorney has to declare the  
2 income on his return and then declare a loss?

3 MR. CARTY: Well, certainly the attorney has a  
4 legal right to those funds. He has a contractual right  
5 and under most --

6 JUSTICE KENNEDY: I'm asking you about the tax  
7 consequences.

8 MR. CARTY: Well, at -- at that point the income  
9 wouldn't have inured to the benefit of the attorney.

10 JUSTICE KENNEDY: Well, but I -- I thought under  
11 your view the moment the client gets the check for the  
12 full amount, one-third of it is taxable to the attorney.

13 And I have some problems, incidentally, with  
14 respect to tax years if it -- if you -- if the client  
15 receives the check December 30 and is on vacation and  
16 doesn't get around to remitting to the attorney until  
17 January 5th, I'm -- I'm not quite sure how your theory  
18 works, but --

19 MR. CARTY: Justice Kennedy, I -- I think the --

20 JUSTICE KENNEDY: But on the absconding theory,  
21 how -- how is it handled from a tax standpoint?

22 MR. CARTY: I believe that for tax purposes the  
23 attorney's right to the funds -- that's at the moment he  
24 receives it. So if he doesn't have the funds in hand, he  
25 wouldn't be liable for Federal tax. It would be at the

1 point he either receives the funds --

2 JUSTICE SOUTER: Aren't -- aren't you --

3 JUSTICE GINSBURG: This is an academic question

4 because he would have an offsetting theft loss.

5 MR. CARTY: I -- I think that is an alternative

6 way to -- to view it. There would be a --

7 JUSTICE SOUTER: If -- if you view it as the

8 theft loss, you -- you maintain your theory. If you

9 argue, as you were arguing a second ago, I think what, in

10 fact, you're doing is adopting the mere lien theory.

11 MR. CARTY: Justice Souter, I -- I --

12 JUSTICE SOUTER: I think you better go with

13 Justice Ginsburg.

14 (Laughter.)

15 JUSTICE BREYER: Like somebody stealing a check

16 out of my mailbox from my employer. Right? Okay.

17 MR. CARTY: Yes.

18 JUSTICE BREYER: So what is your theory, I mean,

19 precisely? A, an assignment of income, what would

20 otherwise count of A giving an assignment of income to B,

21 and therefore still be A's income because the asset

22 remains with A, the work, or whatever. Now, your theory

23 is but not in the case that. Now fill in the blank for

24 me.

25 MR. CARTY: Justice --

1 JUSTICE BREYER: Precisely, please.

2 MR. CARTY: It would not be in the case that the  
3 funds are not under the control of the attorney.

4 JUSTICE BREYER: Not in the case -- it is an  
5 assignment of income to B, but not in the case where the  
6 funds are not in -- when B -- when B get -- when B, the  
7 attorney, gets the funds, he controls them. What's --  
8 what do you mean? I don't get it.

9 MR. CARTY: I thought your hypothetical --

10 JUSTICE BREYER: I want to know. You have three  
11 -- your problem on your side for me is that maybe all the  
12 equities are there, but I'd like to know the proposition  
13 of law that you want us to write in this opinion. And now  
14 we had three theories, and one, the one that you seem to  
15 be adopting, is this exception to the assignment of income  
16 doctrine. If that is what you're adopting, I'd like to  
17 know the precise form of words that create the exception.  
18 If that's not the theory you're adopting, I would like to  
19 know what the theory you're adopting is.

20 MR. CARTY: I would state, Your Honor, that the  
21 assignment of income doctrine simply does not apply when  
22 the -- the client has no control or power of disposition  
23 over the income that was subject to the assignment. There  
24 are at least five reasons why this type of contract --

25 JUSTICE BREYER: He did have control. He could

1 have settled the lawsuit or not settled the lawsuit. He  
2 controlled when the income was generated, and moreover, he  
3 could have stopped it from being generated by settling the  
4 suit or dismissing it. Moreover, if he had not entered  
5 into this assignment of income, it would have been paid  
6 right into his bank account at the end. It sounds an  
7 awful lot like the Lucases or like the Horsts or whoever,  
8 Old Colony Trust. It sounds an awful lot like those  
9 cases.

10 MR. CARTY: Justice Breyer, I -- I think it's  
11 helpful to make a conceptual distinction between the  
12 claim, the underlying litigation claim, and the right to  
13 receive the funds. Now, certainly Mr. Banks in this case  
14 had a right to enter into settlement or not. He had a  
15 right to fire his attorney. But once he assigned the  
16 contingent fee portion of the recovery, he, as a practical  
17 matter, had no ability, he had no control over that  
18 portion of the recovery.

19 Another fundamental difference between --

20 JUSTICE KENNEDY: That -- that would be the same  
21 with the theater agent or the commission agent.

22 MR. CARTY: We submit, Justice Kennedy, that the  
23 nature of the attorney-client relationship is  
24 fundamentally different from the types of relationships  
25 you cited, and that's because an attorney here is the one

1     who's earning the income.  It's the attorney who is making  
2     the critical decisions.

3                 JUSTICE KENNEDY:  Well, you could say the same  
4     thing for the talent scout.

5                 MR. CARTY:  I would respectfully disagree.  I --  
6     I think there's a -- there's a fundamental difference.  
7     Presumably a -- a actor or an entertainer -- their --  
8     their market value is -- already has some type of tangible  
9     value.  The -- the agent might --

10                JUSTICE KENNEDY:  Your client, in effect, earned  
11    the money by having this -- undergo this -- this  
12    discrimination.  That -- that's --

13                MR. CARTY:  Well, Your Honor --

14                JUSTICE KENNEDY:  This is not the plumber  
15    hypothetical, which is I think quite misleading.  No.  No,  
16    I don't think that even the Government will defend that.

17                MR. CARTY:  Again, Your Honor, I think with  
18    respect to an entertainer, an entertainer necessarily  
19    doesn't need an agent.  Neither does an athlete.

20                JUSTICE GINSBURG:  Take an investment advisor  
21    and the client is not at all -- doesn't know anything  
22    about the market, and he's got this whiz-bang advisor who  
23    makes millions for him that he never could have made on  
24    his own.

25                MR. CARTY:  I -- I think that might be more

1 similar to the attorney-client relationship. But Mr.  
2 Banks, unlike the athlete or unlike the entertainer, had  
3 no -- no ability to -- to recover these funds himself. He  
4 essentially had two options. He could have either done  
5 nothing and collected nothing --

6 JUSTICE BREYER: Your -- your -- you want to  
7 fill in the blank, in other words, and say where the  
8 assignment of income is such, such that B was in effect  
9 the person who really earned the income, unlike Mrs.  
10 Lucas' -- Mr. Lucas' or maybe Mr. Earl -- I don't know --

11 MR. CARTY: That's correct.

12 JUSTICE BREYER: -- husband -- the wife didn't  
13 earn the income.

14 MR. CARTY: Right.

15 JUSTICE BREYER: The husband did. So you want  
16 to say where the -- and then your answer, I guess -- don't  
17 say I'm right if I'm not right, please, because I'll just  
18 find out later.

19 (Laughter.)

20 JUSTICE BREYER: The -- the answer to the  
21 hypothetical about the agent and so forth is, well, so be  
22 it. If a person wants to go to the trouble of carving out  
23 some of his income and assigning that over to the agent,  
24 let him. Except for perhaps provisions of the code which  
25 we cannot now envisage -- I can't because I'm not an

1 expert -- it doesn't matter since, after all, it would be  
2 deductible anyway. Is that -- is that what you're saying?

3 MR. CARTY: Well, Your Honor --

4 JUSTICE BREYER: Tell me if I'm wrong, please,  
5 on this.

6 MR. CARTY: Again, I -- what we're saying is the  
7 unique situation of an attorney and a client, it is the  
8 attorney who's taking the laboring, or unlike the  
9 entertainer example where the -- where -- or the athlete  
10 example --

11 JUSTICE BREYER: Okay, I see. You say double.  
12 Both the income is earned by the attorney, and at that  
13 stage the client does virtually nothing. So it's the  
14 reverse of the Earls or the Lucases where the husband was  
15 doing the work and the wife is getting the income. It  
16 would be as if the wife was doing all the work and the  
17 husband just sat there and clipped coupons or whatever.

18 MR. CARTY: That's correct, Your Honor, and in  
19 Lucas v. Earl, it was the assignor who earned the income  
20 that was subject to disposition. Here --

21 JUSTICE GINSBURG: I'm not so sure about that  
22 because why doesn't the theory that -- that applies to the  
23 lawyer equally apply to the wife? I mean, she took care  
24 of everything going on at home, and that enabled him to go  
25 out there and make all that money. So without her

1 services, just like without the lawyer's services --

2 MR. CARTY: That is an excellent point, Your  
3 Honor.

4 JUSTICE SCALIA: You should agree with that.  
5 You should --

6 (Laughter.)

7 JUSTICE BREYER: Those were less enlightened  
8 times.

9 MR. CARTY: Nevertheless -- nevertheless, I -- I  
10 think there may be some -- some difference in degree that  
11 you might even recognize between the two cases.

12 Another issue I'd like to address is the impact  
13 of the fee shifting statutes, if I could get to that  
14 quickly. It is a bedrock principle of taxation that  
15 settlements of a claim are taxed the same as a judgment  
16 would have been taxed. Mr. Banks' settlement was achieved  
17 in lieu of his claims under title VII and 42 U.S.C.,  
18 sections 1981 and 1983.

19 Now, each of these statutes contains a fee  
20 shifting provision which enables a court to award  
21 attorney's fees to a prevailing plaintiff. The defendant  
22 in Mr. Banks' case, the California Department of Education  
23 -- they therefore settled Mr. Banks' claim in lieu of  
24 their exposure under these fee shifting statutes.

25 An award pursuant to these fee shifting statutes

1 is separate and distinct from a damages recovery and  
2 therefore should not be taxable to a plaintiff. And the  
3 Federal tax consequences to Mr. Banks, the litigant who  
4 settles, shouldn't be any different as well. Otherwise,  
5 this Court would be discouraging settlement. Therefore, a  
6 judicial anti-abuse rule should not be misused to  
7 undermine the statutory scheme devised by Congress to  
8 encourage civil rights litigants to bring meritorious  
9 claims and vindicate national policy.

10 Unless the Court has any further questions?

11 JUSTICE GINSBURG: The Government says on that  
12 branch of it, well, the fees -- the lodestar fee, that's  
13 one thing. A court awards it, but that's quite different  
14 from the one-third/one-half even contingent fee. The  
15 court has control over the fee shifting, but we're not  
16 dealing with any court award here.

17 MR. CARTY: That's correct, Justice Ginsburg.  
18 Mr. Banks settled his claims. Yet, we are pressing the  
19 point that Mr. Banks shouldn't be treated any differently  
20 for tax purposes than a litigant who recovers pursuant to  
21 a fee shifting statute. Otherwise, the Court would be  
22 discouraging settlement.

23 If there's any other questions.

24 JUSTICE STEVENS: Thank you, Mr. Carty.

25 MR. CARTY: Thank you.

1 JUSTICE STEVENS: Mr. Salmons, you have a little  
2 over 2 minutes.

3 REBUTTAL ARGUMENT OF DAVID B. SALMONS

4 ON BEHALF OF THE PETITIONER

5 MR. SALMONS: Thank you, Your Honor.

6 It is clear that the only thing that  
7 respondents' attorneys earned under the fee agreements was  
8 the right to be paid a fee for their services. In  
9 petitioner's view, those agreements don't even give rise  
10 to an assignment of income in the ordinary sense. If you  
11 look at the text of the fee agreement in the Banaitis case  
12 -- the Banks' fee agreement is not in the record -- among  
13 other things, it makes clear that if there is a  
14 termination -- and it provides lots of grounds on which  
15 the attorney-client relationship can be terminated -- that  
16 the attorney will be paid a reasonable fee, calculated at  
17 the sum of \$175 per hour. That doesn't sound like an  
18 assignment of any income or even an assignment of the  
19 underlying cause of action. Even if it did, it is clear  
20 that in every assignment of income case, the assignor  
21 loses control over that income that he assigned. That  
22 doesn't stop the application of the proper tax principles,  
23 however.

24 The -- the respondents in these cases suffered a  
25 legally cognizable injury. They had a claim. That claim

1     entitled them to a recovery. They retained services to  
2     pursued that claim. If they had paid their lawyers on an  
3     hourly basis, those lawyers may have been just as  
4     necessary to the actual outcome of the case as their  
5     contingent fee attorneys. Both the -- an hourly fee  
6     attorney and a contingent fee attorney in both of the  
7     States at issue here -- and in fact, in all States of  
8     which I'm aware -- received precisely the same attorney's  
9     lien. That lien makes clear that the relationship between  
10    attorney and client starts out as that between a master  
11    and an agent and then is converted through the fee  
12    agreement to that between a creditor and a debtor, and the  
13    lien secures the debt and ensures its payment. When the  
14    proceeds from the litigation are paid to the attorney, it  
15    satisfies the respondent's debt and is therefore income to  
16    the attorney. Under the separate and alternative ground  
17    of this Court's Old Colony decision, it goes far and  
18    beyond even the holding with regard to an assignment of  
19    income.

20               To address just a couple of questions that came  
21    up, I would point out that in the class action context,  
22    again, as I indicated, there are a number of differences.  
23    And just to be a little more specific about some of them,  
24    generally speaking there's no unilateral right to settle a  
25    -- a case by class members. There's no unilateral right

1 to dismiss the case, and there's no right to a determined  
2 fee.

3 JUSTICE STEVENS: Thank you, Mr. Salmons.

4 MR. SALMONS: Thank you.

5 JUSTICE STEVENS: The case is submitted.

6 (Whereupon, at 11:00 a.m., the case in the  
7 above-entitled matter was submitted.)

8

9

10

11

12

13

14

15

16

17

18

19

20

21

22

23

24

25